Profile of the Economy

[Source: Office of Economic Policy, Office of Financial Analysis]

Real gross domestic product

Economic growth slowed in the third quarter, with real gross domestic product (GDP) rising at a 2.2 percent annual rate following an increase of 4.7 percent in the second quarter. Despite the slowdown, growth so far this year is 2.9 percent at an annual rate, better than the performance in 1995 when real GDP rose by just 1.3 percent.

The third quarter was held down by a sharp slowing in consumer spending, which edged up at a 0.4 percent rate after rising at a rapid 3-1/2 percent pace over the first half. Net exports continued to be a drag on growth, and government purchases declined. Total real final sales grew at only a 0.3 percent rate in the third quarter, with large accumulation of inventories accounting for almost all of the gain in total GDP in the quarter.

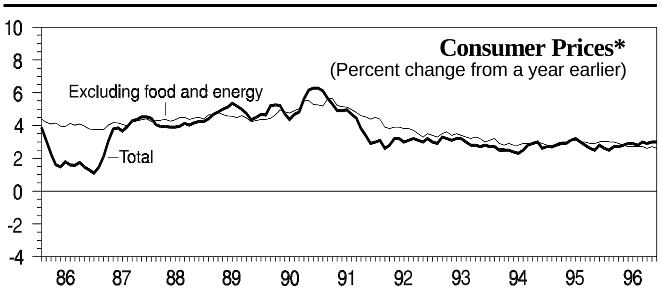
One bright spot in the third quarter was a pickup in nonresidential fixed investment, particularly for equipment. Equipment investment rose at almost a 19 percent annual rate, its fastest in 2 years.

Inflation, as measured by the chain-weighted price index for GDP, moderated in the third quarter to 1.9 percent at an annual rate from 2.2 percent in the first half. Prices paid by U.S. residents, excluding exports and including imports, rose at a 1.8 percent rate.

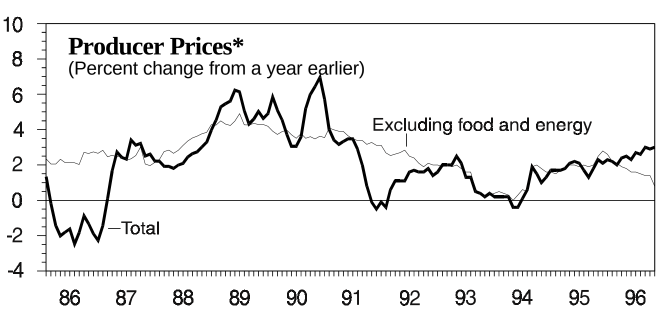
Consumer and producer prices

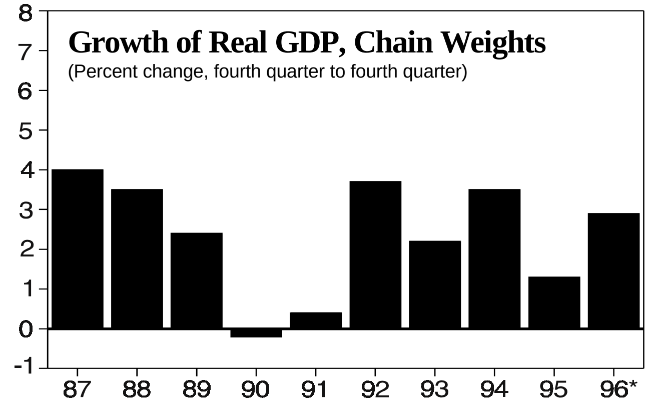
Inflation has remained moderate through most of 1996 despite some acceleration in energy and food prices early in the year and again in recent months. Underlying inflation, excluding food and energy, has stayed low throughout the year.

The consumer price index (CPI) rose by an annual rate of 3.3 percent through the first 10 months of this year compared with an increase of 2.5 percent in 1995. Most of the pickup was due to higher energy and food prices. Excluding those items, the "core" rate of inflation was just 2.8 percent in the first 10 months, below the rate of increase last year.



*Year tick marks correspond with June data.





*First three quarters at an annual rate.

The producer price index (PPI) for finished goods has been favorable. The PPI was up at a 2.4 percent annual pace in the first 10 months of this year after rising by 2.3 percent over all of 1995. Excluding food and energy, this year's gain has been just 0.4 percent at an annual rate, well below the 2.6 percent increase last year. Core prices at earlier stages of processing also have been very well behaved so far this year.

The cost of compensating labor has shown little evidence of driving up prices, as more rapid growth in wages and salaries in the first 3 quarters of the year has been partly offset by slower growth in benefit costs. The employment cost index (ECI) rose by 2.8 percent over the 12 months ending in September, a shade above the 2.7 percent gain during 1995.

Real disposable personal income and consumer spending

Real disposable (after-tax) personal income rose at a strong 4.9 percent annual rate in the third quarter. So far this year, growth has averaged a more moderate 2.7 percent annual rate, a little less than the 3.1 percent increase over all of 1995. The composite of growth this year is nonetheless favorable. Real wage and salary income has increased faster this year than last. A smaller rise in interest income with higher tax payments, reflecting in part the last installment of the 1993 tax hike on upper-bracket incomes, accounts for most of the slowdown in total after-tax income.

Real consumer spending has picked up this year, averaging a 2.4 percent rate of growth over the first 3 quarters of 1996, compared to 1.9 percent over all of 1995. Spending rose at a 3-1/2 percent annual rate during the first half of the year but slowed abruptly to only 0.4 percent in the third quarter.

With income growing but spending little changed in the third quarter, the share of after-tax income devoted to personal saving rose to 5.4 percent from 4.3 percent in the second quarter. The personal saving rate has averaged 4.9 percent so far this year, up slightly from 4.7 percent in 1995 and a low 3.8 percent in 1994.

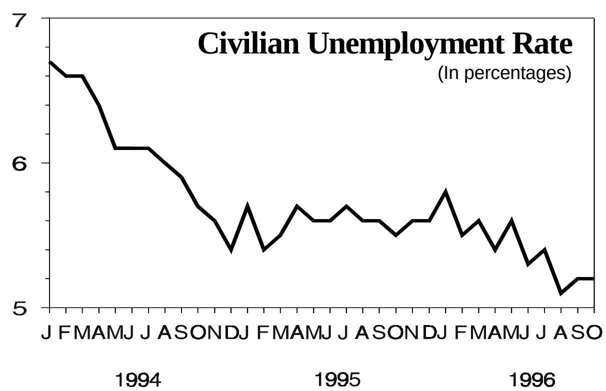
Industrial production and capacity utilization

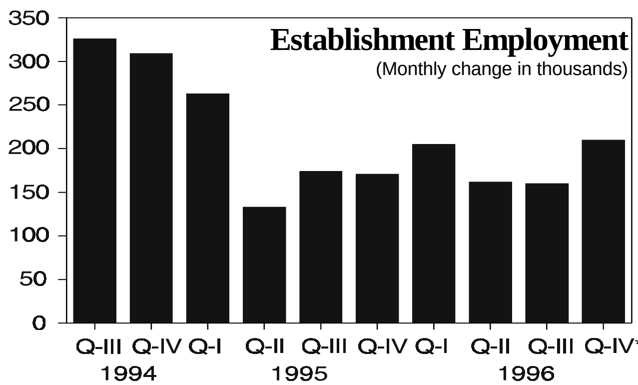
Industrial production in manufacturing, mining, and utilities has risen at a 3.7 percent annual rate this year compared to only 1.1 percent during all of 1995. Production fell 0.5 percent in October, after increases averaging 0.4 percent in the prior months of the year. Strikes affecting motor vehicle assemblies at General Motors accounted for most of the drop, but even excluding motor vehicles, output edged down 0.1 percent in October. One area of continued strength is the manufacture of computer equipment.

Expansion of industrial capacity has picked up to a 4 percent annual rate this year, roughly doubling its pace of growth from earlier in the decade. Faster growth of capacity, combined with weak growth of production during 1995, has allowed the industrial capacity utilization rate to retreat from a 15-year high of 85.1 percent reached in January 1995 to 83.4 percent in July through September 1996. Utilization fell further to 82.7 percent of capacity in October, reflecting the drop in industrial production.

Employment and unemployment

Job growth of nonfarm establishment payrolls has accelerated in 1996 to 209,000 a month from 185,000 a month, or a total of 2.2 million jobs, last year. While less than monthly gains averaging 318,000 during 1994, the current pace of advance still amounts to a 2 percent annual rate. That is about double the growth in the working-age population. Job growth turned slightly negative in September, pulling the average monthly increase for the third quarter down to 160,000. In October, the number of jobs rose by 210,000.





*Based on data for October.

Strength over the past several years has been centered in the private service-producing sector of the economy, which accounted for virtually all of the 2.2 million job growth last year. An additional 1.8 million private service-sector jobs have been added over the first 10 months of 1996. Manufacturing has been weak during the past year and a half, losing more than 320,000 jobs since March 1995.

The unemployment rate fluctuated in a narrow band near 5.5 percent between late 1994 and spring of 1996. Unemployment began to ease further and by August had fallen to 5.1 percent of the civilian labor force, the lowest reading since March 1989. In September, the unemployment rate edged up to 5.2 percent, where it remained in October.

Nonfarm productivity and unit labor costs

Nonfarm productivity, or real output per workhour, edged up at only a 0.2 percent annual rate in the third quarter and by a 0.9 percent pace over the first 3 quarters of 1996. Growth so far this year reflects improvement from increases of just 0.5 percent and 0.3 percent, respectively, during 1994 and 1995, and a small decline during 1993.

Hourly compensation costs in the nonfarm business sector rose at a 3.9 percent annual rate in the third quarter, and are up at a 3.7 percent pace this year compared to 4.1 percent last year. With productivity improving and compensation costs slowing, labor costs per unit of output in the nonfarm sector, a key indicator of potential inflationary pressure, have slowed to a 2.8 percent annual rate of growth so far this year, from 3.8 percent last year. Results for 1996 are influenced by a low result for the first quarter. Growth in the second and third quarter averaged 3.5 percent.

Productivity in manufacturing, included in the nonfarm sector, remains strong. Factory productivity was up at a 4.8 percent annual rate over the first 3 quarters of 1996, contributing to a 1.2 percent annual rate of decline in unit labor costs.

Current account balance

The current account is the broadest measure of U.S. transactions with the rest of the world, covering not only trade in goods and services but income flows as well. The current account deficit widened sharply in recent years as the economic recovery here brought in imports at a faster pace than the rate of expansion in exports.

The deficit grew from a recent low of $10 billion in 1991 to a high of $148 billion in both 1994 and 1995. Through the first half of this year, the current account deficit was little changed from the pace of last year.

The merchandise trade component posted a $173 billion deficit in 1995, the largest on record. In the first half of 1996, the merchandise trade deficit widened even further, to $179 billion at an annual rate.

International trade in services showed a $68 billion surplus in 1995, a new record. In the first part of 1996, the surplus in services trade continued to grow, to a $75 billion annual rate.

The balance on income payments, which includes interest, dividends, and direct investment income, shifted from a surplus of $10 billion in 1993 to a deficit of $8 billion in 1995. Much of that deficit reflected Federal Government interest payments to the rest of the world. The deficit on income payments narrowed in the first half of 1996.

Exchange rate of the dollar

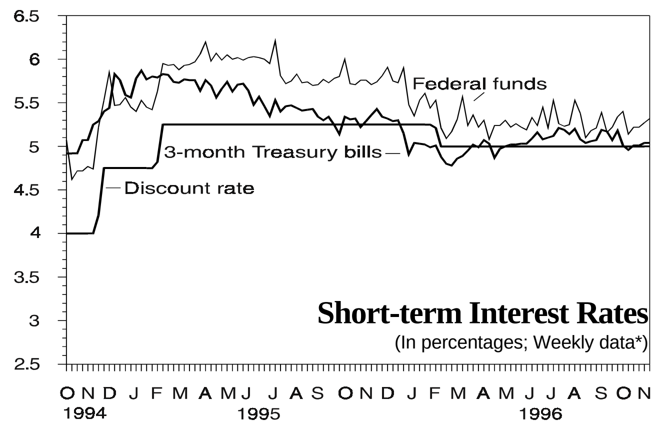
The dollar has strengthened since the middle of 1995 after steady deterioration beginning in early 1994. Based on the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies, the dollar dropped to close at an all-time low in April 1995. Since then, the dollar has risen by 7-1/2 percent. There was some deterioration in July and August, but the dollar improved in September and October.

Most of the dollar deterioration in 1994 was against the yen and the deutschemark, and the improvement was also greatest against these currencies. Since April 1995, the dollar has increased by more than 10 percent against the deutschemark and by 34 percent against the yen.

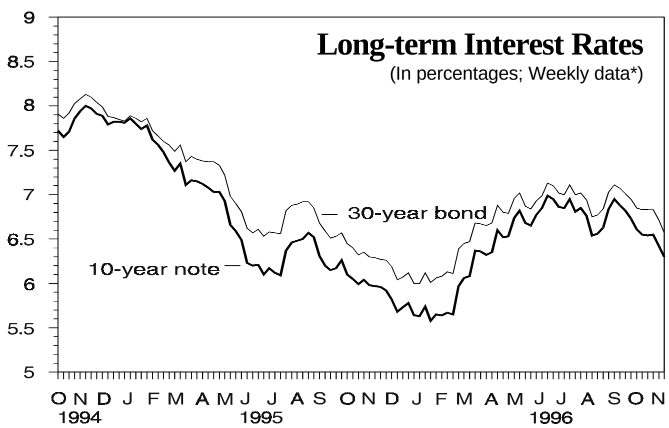
Despite the improvement, the dollar remains about 9 percent below its recent high of January 1994. Many factors determine the level of exchange rates in international currency markets. The large U.S. current account deficit likely played a role in the earlier downward movement of the dollar. Underlying economic fundamentals in the United States remain sound, however.

Interest rates

Long-term interest rates moved higher early in 1996 as the economy expanded and there was some upward pressure on prices, but rates have eased recently with reports of slower economic growth and moderating inflation. The yield on the 30-year Treasury bond dipped from a recent high of 7.1 percent in September to about 6.5 percent currently.



*Average for week ending Friday; Federal funds ending Wednesday.



Mortgage interest rates have been favorable. Early this year the rate for a 30-year fixed-rate conventional loan was 7 percent, close to the 25-year lows reached in October 1993. A pickup during the middle of the year apparently had little dampening effect on the housing market, and since the summer, rates have declined to less than 7-3/4 percent. This is quite low by historical standards.

Short-term interest rates have fluctuated around 5 percent through most of the year. The Federal Reserve Board has kept short-term rates stable since January as economic growth reached a moderate pace consistent with low inflation.

Net national saving and investment

In the first half of 1996, net national savings, excluding depreciation to replace worn-out or obsolete equipment and structures used in production, rose to 5.8 percent of net national product (NNP) from 5.1 percent averaged in 1995 and as low as 2-3/4 percent in both 1992 and 1993. Despite the gains, net saving remains less than half as high as the 12 percent of NNP averaged in the 1960's.

Recent improvement is mainly the result of narrowing of the Federal deficit. That has reduced Government dissavings to 1 percent of NNP in the first half of 1996 from 4.8 percent in 1992. Private saving, of households and businesses, was equivalent to 7.3 percent of NNP in the first half, up a little from a historical low of 6.4 percent in 1994. Even so, private saving is still well below the nearly 10 percent of NNP averaged in the 1960's and 1970's.

Net domestic investment equaled 7 percent of NNP in the first half, up from a low of 4.1 percent in 1991. Foreign inflows accounted for 2.1 percent of NNP this year, or nearly one-third of domestic investment. U.S. sources provided investment equivalent to 5 percent of NNP, less than half the share of NNP averaged in the 1960's and 1970's.

Housing

Housing activity remained very strong through most of 1996 despite some upturn in mortgage interest rates in mid-year. Housing starts in the first 10 months averaged 1.47 million units at an annual rate. If growth is maintained through the rest of the year, 1996 would be the best year for home building since 1988.

Sales of new homes eased slightly in September, but remained close to the 10-year high set in August. Over the first 9 months of the year, sales of new single-family homes were nearly 15 percent higher than in the same period last year. The homeownership rate rose to 65.6 percent in the third quarter, the highest in 15 years.

Higher mortgage interest rates were expected to dampen housing activity, but strong growth in employment and consumer confidence and a shift toward lower-cost adjustable rate loans have kept housing demand high. Fixed rates for a 30-year loan rose from levels of about 7 percent in January and February, which were near 25-year lows, to nearly 8-1/2 percent during the summer. Since then mortgage rates have come back down to 7.6 percent, very favorable by historical standards.

Federal budget deficit

The Federal budget deficit fell to $107.3 billion in fiscal 1996, the lowest in 15 years and about $57 billion below the level of the previous fiscal year. As a share of gross domestic product (GDP), the deficit is 1.4 percent, the smallest share since 1974.

The deficit has been shrinking since fiscal 1992, when it reached an all-time high of $290 billion. Since then, the deficit has been cut by almost two-thirds, or a total of $183 billion. Strong economic growth and passage of the Omnibus Budget Reconciliation Act of 1993 set the deficit on its downward course.

In fiscal 1996, receipts grew by 7.6 percent due to strong growth in jobs and income, corporate profits, and stock market returns. Growth in outlays was held to 3 percent over the fiscal year. Receipts as a share of GDP rose to their highest level since the early 1980's, while the outlay share declined to its lowest since fiscal 1979.

The deficit is projected to fall further in succeeding fiscal years. It will reach balance by 2002 under either Administration or Congressional Budget Office economic and technical assumptions. ◊